



Dealing with Greenspan's Conundrum

Sam Park – February 2005

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February Minutes of the Federal Open Market Committee

The Federal Open Market Committee (FOMC) continued with its effort to increase transparency by revealing the minutes of its February meeting. The minutes disclose the discussion among the members as they had decided to raise fed funds rate 25 basis points to 2 ½ percent. This transparency allows the public to scrutinize and analyze reasons behind the Committee's decision on their recent monetary policy.

During the meeting, the consensus was that the economy steadily expanded in recent months. Real consumer spending continued to expand as real disposable personal income rose moderately and consumer confidence remained favorable. New and existing home sales maintained their robustness, however at a decelerating rate. Business fixed investment grew in the fourth quarter and was bolstered by favorable fundamentals. Since the recent data indicates a solid economy, the FOMC has some freedom to raise rates closer to their neutral level that ranges between 3.5 and 4 percent.

A Large Trade Deficit and a Weak Dollar

U.S. international trade deficit continues growing to record levels, both in nominal terms and percent of GDP. Recent data suggests that the U.S. trade deficit had swelled in the fourth quarter, which had resulted from a decline in exports of goods and increases in imports of oil and consumer goods. Despite the optimistic view of the U.S. economy suggested in the February minutes, the current trade deficit may pose a threat to the ability of sustaining high Federal deficit levels and to the continuing of the economic expansion.

Large deficits typically cause worry that they could hurt the U.S. industry, eliminate jobs, and cause "hard landing" scenarios. Growing deficits could burden future generations with overwhelming foreign debt, leaving the U.S. susceptible to foreign pressures. This could discourage foreign investor confidence in the U.S. and may trigger capital flight, causing a downward spiral of the dollar.

However, according to [America's Record Trade Deficit](#), large trade deficits are typically accompanied by improving economic conditions because of the link between trade deficits and rising investments. The primary cause of the U.S. trade deficit is due to insufficient domestic savings to fund all available domestic investment opportunities. This insufficient savings is filled by inflow of foreign capital, which allows the U.S. to buy more than it sells resulting in a trade deficit. Trade deficits are sustainable as long as the U.S. remains a safe and profitable designation for the world's savings.¹

¹ <http://www.freetrade.org/pubs/pas/tpa-012.pdf>



Several factors challenge the sustainability of the trade deficit. Historically, the U.S. dollar and Treasuries have been viewed as safe and profitable. While the dollar is still safe, several major dollar-holding foreign central banks had recently issued statements of the dollar's unsatisfactory returns. These central banks have also indicated their plans of decreasing their exposure to the dollar, and these banks may diversify themselves away from the dollar. The weakened dollar must turnaround to avoid a possible capital flight and recession.

Inflationary Pressures

Another major focus on the Committee's minds is inflation. The weak dollar has caused import prices to rise. This combined with record high crude oil prices are creating inflationary pressures. High productivity growth rates have previously eased such pressures; but as the productivity rates decelerate, core inflation to the consumer will begin to increase.

The latest core Producer Price Index rose .8% (its highest monthly jump in nearly a decade). This implies that costs to firms have risen. The rise in the latest core Consumer Price Index was more moderate. However, unit labor costs had accelerated over the last year; and if this trend persists, core CPI is likely to increase.

The FOMC puts more focus on CPI figures than that of the PPI, and the Committee does not currently seem to be in a panic situation. Then again, some firms/producers have indicated their ability to pass cost increases to product prices, which directly causes higher core CPI figures. FOMC members probably understand this possibility and may take a more aggressive monetary stance in the months ahead.

Contradictory Interest Rate Situation

As shown in my previous newsletter, consumer inflation levels affect FOMC's policy stance and decisions on fed funds rates. Given so, the upward inflationary pressures will force the Committee to take a tighter stance, which will effectively increase short-term interest rates. Nonetheless, consequences result from actions.

Greenspan has mentioned how he faces a conundrum seeing the recently declining long-term Treasury rates after having raised rates six consecutive times. Rising short-term rates not only causes a flattening yield curve, but the low long-term rates also accelerates the process. This implies that economic outlook appears uncertain. If the curve becomes inverted (when short-term rates exceed that of longer-term Treasuries), then we are likely to face a dismal economic situation.

Where Fed Funds Rates Are Headed

As mentioned, the FOMC tends to focus majority of their attention on consumer's inflation. Granted so, they will continue raising target rates. Currently, the fed fund futures is pricing approximately 65% probability of a 50 basis point increase in fed fund rates vs. 35% no move during the upcoming FOMC meeting. However, comparing 50 bps vs. 25 bps results 92%



probability of a 25 bps vs. 8% of a 50 bps increase. This implies that at least 25 bps rise is virtually definite in their meeting on March 22nd.

Summing It Up

The Federal Reserve forecasts real GDP to expand between 3 ½ and 4 percent for 2005, and the Committee expects the pace to slightly decelerate and range between 3 ¼ and 3 ¾ percent in 2006. Firms surveyed by the Fed have indicated more confidence about the economic outlook, and a significant reduction in capital spending is not anticipated in the early part of 2005. Both firms and consumers have taken advantage of low longer-term nominal interest rates, which is partly attributable to well-contained inflation expectations.

The low rates have discouraged savings and helped sustain spending trends. The current low savings rate appear to have resulted by expected income gains, low interest rates, and higher household wealth. The rise in equity and housing prices were major factors in creating that wealth. A reversal of home price appreciation trends would adversely affect household wealth.

A downward spiraling home price or bursting of a housing bubble is possible only if a negative catalyst occurs (i.e., unemployment rates taking a sudden and sharp hike). Since this scenario appears doubtful in the foreseeable future, downside economic risk seems contained. A bleak economy can be avoided as long as imbalances do not force the FOMC to considerably deviate fed fund rates away from neutral levels.

The Federal Reserve Board will most likely raise rates 25 bps on March 22nd. However, if Greenspan fears that increasing inflationary pressures to the consumer is strong and eminent, the FOMC may opt to raise more aggressively by 50 bps during the March meeting.

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